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TAGS: ECON EFIN PREL CH
SUBJECT: U.S. Federal Reserve Nov. 18-20 Visit to Beijing:
Recovery, Rebalancing, and Reform

¶1. (SBU) Summary. Chinese officials and local and foreign bankers and economists told visiting Federal Reserve Governor Warsh and San Francisco Fed President Yellen that China's GDP growth has been boosted by successful fiscal and monetary policies, largely focused on infrastructure investment, and should reach 8.3-8.4 percent in 2010. Massive new bank lending over the past year may lead to an increase of non-performing loans (NPLs) in 2011 and beyond, but the government has the fiscal capacity to intervene if necessary. Discussion of stimulus exit strategy already is under way within the government, but is complicated by perceived needs to further consolidate economic recovery while avoiding any resurgence of inflation that could provoke social instability. Some Chinese contacts are concerned about the U.S. recovery and revival of external demand for China's exports, while other observers view resumption of fiscal, social security, and financial sector reforms that would promote longer-term economic rebalancing as more important and urgent needs.

¶2. (SBU) Summary, continued. One government economist said China is taking a two-step approach toward managing the economy: first, arrest the downturn -- which has been done -- and then continue the rebalancing that began before the crises. For that reason, the focus of 2010 stimulus spending will shift from large-scale infrastructure projects to social sectors, including health and education, low-income housing, and training. Job creation, primarily in the services sectors, also will be a key concern. While China has made some progress toward rebalancing, most economists urge further opening of the service sectors to private sector participation and measures to make urbanization "more permanent" by regularizing the status of migrants and their families, which would generate more labor-intensive service-sector urban growth. While one official said the Chinese Government's fear of rising unemployment hinders significant near-term RMB appreciation, several economists said there is widespread recognition that the currency is undervalued and that broader price reform also is needed to sustain growth. Several contacts raised concerns regarding the U.S. economic and fiscal situations, including the possibility of a "W-shaped" recovery, the danger of high inflation that would erode the value of China's USD-denominated investments, the rising U.S. fiscal deficit, the downward trend of the U.S. Dollar, and the current high unemployment level. End Summary.

¶3. (SBU) During their November 18-20 visit to Beijing,

U.S. Federal Reserve Governor Kevin Warsh and Federal Reserve Bank of San Francisco President Janet Yellen discussed a broad range of U.S., China, and global economic and financial topics with senior Chinese officials and Chinese and foreign bankers and economists. The Federal Reserve delegation met with Executive Vice President Wang Yiming of the Academy of Macro-economic Research (AMR), National Development and Reform Commission (NDRC); Vice Chairman Gao Xiqing, China Investment Corporation (CIC); Vice Chairman Yao Gang, China Securities Regulatory Commission (CSRC); Vice Minister Liu He, Central Leading Group (CLG) on Financial and Economic Affairs; and other Chinese bankers and officials. The Fed visitors also participated in a roundtable discussion with five Beijing-based economists: Senior IMF Resident Representative Vivek Arora, UBS Head of China Economic Research Wang Tao, Dragonomics Managing Director Arthur Kroeber, World Bank Senior Economist Louis Kuijs, and Guanghua School of Finance Associate Professor Michael Pettis.

China's Economy: Successful Stimulus Policies

¶4. (SBU) According to NDRC/AMR Vice President Wang, domestic factors caused China's economic growth to slow in the third quarter of 2007, a trend then accelerated by the global crisis. Government stimulus programs reversed this momentum in the second and third quarters of 2009, bringing GDP growth for the first nine months of 2009 to 7.7 percent. Of this total, investment contributed 7.1 percent, consumption four percent, and net exports negative 3.6 percent. Wang expected fourth quarter GDP

growth to be higher due to the low base of fourth quarter ¶2008. He said the consensus estimate for 2009 GDP growth was 8.3-8.4 percent. For 2010, Wang believes two key growth engines, investment and consumption, might moderate as investment in real estate slows and government programs to promote consumption wind down. Vice Minister Liu He said China's 2010 GDP growth should reach eight percent or higher, based in part on expectations of two percent U.S. GDP growth (three percent globally).

¶5. (SBU) Although some observers questioned the stimulus focus on infrastructure construction, Dragonomics' Kroeber said China had huge infrastructure needs so this spending had not been wasted. Several hundred million people needed relocation to the cities, requiring much more infrastructure, and some funded projects are anticipatory or addressed economic transformation, such as the high-speed railways. At worst, he believed China had "borrowed" some future growth by front-loading infrastructure spending. UBS' Wang agreed, observing that China was going through rapid industrialization for which it "cannot have too much" capital stock. The primary concern was whether there was any misallocation of resources, not whether there was an overall excess. Kroeber also observed that China's use of bank credit rather than fiscal revenue to finance much of the fiscal stimulus enabled it to "postpone indefinitely" any repayment problems that arose. If the stimulus program was extended for multiple years, however, the financial burden might cause problems.

¶6. (SBU) Asked whether Chinese banks were encouraged to extend stimulus lending to preferred entities, one senior Chinese bank executive said his state-owned bank had "never been asked to lend to special projects." He observed that China, unlike the United States and the European Union, still had a low overall debt ratio and considerable space to increase lending and domestic consumption. The banker conceded, however, that new bank lending often flowed to industries with overcapacity, rather than Beijing's preferred recipients. He also

claimed the central government issued careful guidance on the types of business allowed to receive loans, as it wanted to support private consumption and investment through small and medium-sized Chinese enterprises.

NPLs: Future Concern

¶7. (SBU) In part due to credit flowing to certain industries already burdened with overcapacity, the IMF was worried about a resurgence in non-performing loans (NPLs). Arora said loans extended to households and infrastructure projects were not concerns, but 60-70 percent of the stimulus-fueled credit expansion is "dark matter." Nonetheless, he believed NPLs were a concern for 2011-12, if not 2009-10, but he did not expect the NPL ratio to reach double digits, as it has in the past. Also, the government had the fiscal capacity to intervene if necessary. The IMF considered loan growth of 17 percent in 2010 credible, but a more rapid increase would be worrisome. Guanghua's Pettis echoed Arora's concern about this year's lending flood, opining that the massive increase was a step backward for China's banks. He also believed there was considerable hidden debt at the provincial and local levels, while large amounts of old bad debts (from the banks previous quasi-fiscal role supporting state-owned entities) had not been fully resolved. Kroeber agreed, noting that government and bank statistics did not reveal the entire debt, although he also said the government had hidden assets that could be "unlocked," as was done through housing reform in the late 1990s.

Exit Strategies: When and How?

¶8. (SBU) CSRC Vice Chairman Yao said discussion of stimulus exit strategy had begun, since China's proactive policy measures enabled it to recover earlier than other countries. He was not certain this year's eight percent GDP growth rate was sustainable; if not, then exit from the stimulus would be premature. Yao believed China faces a dilemma: with real economic recovery not yet

assured and consumer price inflation still negative, China was likely to continue the stimulus package; at the same time, however, Beijing already had injected enormous liquidity into the markets, so asset price bubbles might arise. Noting that China's equity market had risen almost 100 percent since its lowest point, and that the current price-to-earnings ratio was almost thirty, Yao believed China's recovery had been too fast. It had been fueled by government investment and bank loans, which needed to be replaced as primary drivers by private consumption. Until that happened, Beijing was adjusting policies slightly rather than moving to an exit. Vice Minister Liu also worried about potential "bubbles" developing in Hong Kong, Shanghai, and Beijing real estate markets.

¶9. (SBU) Several of the roundtable economists broadly confirmed Yao's assessment. The IMF's Arora said the government was not convinced the recovery was here to stay, so it probably would continue fiscal stimulus through 2010 while gradually unwinding monetary measures. Wang of UBS observed that China was concerned about the U.S. recovery and also debating how serious the crisis really was, given the quick recovery of many indicators, and the outcome of this assessment would affect both exit timing and measures to address structural imbalances. She believed Premier Wen Jiabao was worried about the "doomsday scenario" and was reluctant to "take the foot off the pedal" too soon, so the concern was that China would tighten too late rather than too early. Wang also said the central government was opposed to a sharp credit curtailment, so for 2010 there was risk that prolonged loose credit would bring a "boom and bust" scenario.

Other Concerns

¶10. (SBU) Various interlocutors listed other concerns for the short term. According to Wang of the NDRC/AMR, two major uncertainties were recovery of external demand and rising inflationary pressure, which would have serious implications for macro-economic decision-making in 2010. He said China needed both to stabilize economic growth and to stem inflation next year, which would be difficult. For external demand, the United States was a key factor: for every one percent decline in U.S. GDP, China's exports fell five percent. Kuijs said the World Bank was not concerned about inflation, as the supply side was responsive, but fiscal, social security, and financial sector reforms -- all of which faced political obstacles -- were important and/or urgent.

Rebalancing

¶11. (SBU) NDRC/AMR Vice President Wang said the government was taking a two-step approach toward managing the economy: first, arrest the downturn -- which had been done -- and then continue the rebalancing that began before the crises. For that, China needed to boost consumption by increasing the role of the domestic economy, rather than exports, in economic growth. More investment in social welfare, including health care, rural, education, and pension programs also was needed. In that regard, CLG Vice Minister Liu said China's 2010 stimulus spending would approach 2009 levels, but the focus would shift from large-scale infrastructure to health, education, low-income housing, and training. He noted China's needed to address production overcapacity, while cautioning that a premature U.S. economic recovery might soften China's efforts to enact deeper, more painful rebalancing reforms. Liu said China's foremost challenge would remain job creation, with a particular focus on services.

¶12. (SBU) Arora (IMF) observed that if the global crisis resulted in increased household income and consumption as well as good infrastructure investments in China, then it would be seen as good for China; if, however, China responds as it has in the past -- with more investment in manufacturing -- then the crisis would be a negative influence. For now, the IMF saw more of the former than the latter, and China also had made progress on boosting pensions and other social security programs to encourage household consumption. China also had taken measures to

improve availability of financing for small firms, and to reform corporate dividends. Arora said the country's primary goal was employment, for which service sector growth was more beneficial than manufacturing.

¶13. (SBU) The World Bank's Kuijs said China had begun to address its neglect of social safety net, environment and energy problems with its eleventh five-year plan (2006-10). This plan was a good vision with advances in some areas (e.g. pricing and environment), but overall progress had been insufficient to alter the course of the "very heavy ship" of China's growth pattern. Kuijs said most economists offered similar policy recommendations: open the service sectors to private sector participation and make urbanization "more permanent" by regularizing the status of migrants and their families, which would generate more labor-intensive service-sector urban growth. At present, migrant workers were not really involved in the urban economy.

¶14. (SBU) UBS' Wang agreed with Kuijs' analysis, observing that China essentially had a system of "dual citizenship" based on place of birth (urban verses rural). A more important factor for rebalancing, however, was

that local officials were judged by their GDP growth rates, and capital-intensive growth tended to be faster, so the government needed to change the incentive system for these officials. There also was a bias in the tax system, as services were taxed as revenue and this type of tax was difficult to collect, so local officials were not eager to encourage further development of the service sector. Finally, there were many state-owned monopolies in the services sector that did not welcome competition; the government often cited "strategic" or "national security" justifications for these monopolies.

¶15. (SBU) Pettis (Guanghua School) argued that expectations of a coming surge in private consumption were overblown, primarily due to constraints on household income and channeling of capital from households to industrial sectors. Traditionally low interest rates also were a part of this problem that was not likely to improve in the near future, as state-owned enterprise (SOE) profitability depended on low interest rates. Pettis said policies to remove subsidies enjoyed by SOEs and to reverse flows away from household sector were needed, but the transition to a more consumption-based economy would be gradual. He believed rechanneling capital to small and medium-sized companies and the service sectors would produce a large growth burst, but required a political decision. Pettis estimated, however, that even without major economic restructuring, and assuming no unexpected major problems, China should average 5-7 percent GDP growth over the next 5-10 years. If the U.S. no longer absorbed China's exports, then the nature of the problem changed and China's development model no longer worked.

¶16. (SBU) Kroeber (Dragonomics) offered two general observations: first, although the nature of China's challenge now was qualitatively different than in the past, China's policy mechanism had earned the "benefit of the doubt" due to past success; and second, for any self-sustaining growth mechanism, whenever the state retreats there is an automatic productivity increase. China had serious structural issues to address, and after thirty years of using capital accumulation to increase labor productivity, now the "demographics were turning negative forever." Kroeber believed, however, that China had sufficient "breathing space" to keep growth going while making structural adjustments. The key was to ensure capital pricing was correct; if not, then China would "hit a wall" in the 2020s when demographics were most negative.

Exchange Rates

¶17. (SBU) Vice Minister Liu said the Chinese Government's fear of rising unemployment prevented near-term currency appreciation, but added that "some market-oriented reforms" would continue. Wang of UBS said the People's Bank of China wanted to "untie at least one hand" (for monetary policy) by allowing more exchange rate

flexibility, as noted in its latest monetary policy report, but did not have the deciding voice on this issue. She dismissed the negative coverage of the exchange rate issue in the foreign media during President Obama's visit to China, observing that references to adjusting "relative prices" in the joint communiqu essentially referred to exchange rates. Wang said "everyone agrees" the RMB was undervalued; since land and energy also are under-priced, fixing those imbalances would be equivalent to a real exchange rate shift. She expected to see an exchange rate adjustment in 2010. Similarly, the IMF's Arora said the exchange rate issue did not stand alone and was part of a broader problem of relative prices and reorienting investment away from the tradeable sectors. China's moves on prices, social safety net, etc., had

been in the right direction, but the exchange rate had moved in the wrong direction, so the world's largest surplus country had a depreciating currency. Arora also believed European governments should be complaining about RMB depreciation. CIC Chairman Gao said his company must be RMB-neutral, but the PRCG was under pressure to appreciate its currency, which he thought Beijing eventually would do.

¶18. (SBU) Kroeber of Dragonomics said there was a clear inflationary risk for asset prices in 2010, closely related to the exchange rate issue. China had deferred exchange rate appreciation for several years, but next year it would need to choose between appreciation and a rise in inflation. China no longer could "fudge" the issue through sterilization. It was difficult, however, because the government "hates" both exchange rate appreciation and inflation, the latter because it was socially destabilizing (he believes this "paranoia" is exaggerated). China tried gradual appreciation from 2005 to 2008, with bad consequences: the rest of the world "threw capital" into China.

U.S. Economy

¶19. (SBU) Several contacts raised various concerns regarding the U.S. economic recovery. AMR Vice President Wang said the NDRC closely followed U.S. economic developments, including the prospects for a "W-shaped" recovery. CLG Vice Minister Liu worried that the U.S. might revert to old patterns if deep reforms did not take hold, possibly resulting in high inflation that would erode the value of China's USD-denominated investments. He also questioned whether U.S. stock indexes and global commodity prices were climbing too rapidly, and suggested capital flight from the U.S. may be to blame for current Asian asset "bubbles." Similarly, CSRC Vice Chairman Yao opined that interest rates in the United States were driving capital flows into emerging markets, such as Hong Kong. He also said China was concerned about future U.S. fiscal and monetary policies as well as the rising U.S. fiscal deficit and the downward trend of the U.S. Dollar.

¶20. (SBU) CIC Vice Chairman Gao said the United States was unique due to the size of its economy; with eighty percent of its valuation in U.S. dollars, CIC's view of the United States and the USD also was rather unique. At the same time, however, CIC has liabilities in RMB. Gao said CIC "becomes nervous" when it looked at how much money the United States had been printing, and they believed a U.S. policy mistake could induce a double-dip recession or a major fall in the market. CIC's head of strategic research said he agreed the U.S. economy and U.S. companies were dynamic, noting that the United States was more flexible in restructuring but the European Union could more easily accommodate unemployment due to its social system. He believed it was difficult for the United States to have unemployment above ten percent, as that would induce problems in the social security network.

¶21. (U) The Federal Reserve delegation has cleared this report.

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